The CEO of a portfolio company is often given considerable latitude when selecting the CFO or another member of the executive team.

In the case of the CFO there is no other professional business relationship that is closer to the CEO than that of the financial executive. The CFO is typically an advisor, counselor, confidant and sometime mentor to the CEO concerning the most sensitive issues of the enterprise.

When a CEO takes on a new assignment, often the existing CFO is the first to depart followed by the immediate appointment of the new CFO. Chances are the new CFO has worked for the CEO in the past. The incoming CFO is often introduced to the private equity investors, not as a candidate to be considered, but as the CEO’s choice as a member of the executive team.

For all intents and purposes the announcement of the new CFO signals that the nucleus of a new high performing team has been formed. One that will drive earnings and deliver better EBITDA performance—a needed addition to most investments today.

It is the foundation of this relationship that warrants consideration and can be problematic—particularly in a leveraged environment. An analogy can be made between a well-capitalized business and a leveraged business to that of driving an automobile at 40 miles vs. 80 miles per hour. At 40 miles per hour, one has time to think, prepare and act. At 80 there is precious little time and even a small error in judgment can turn into a disaster. Leverage compounds results—both positively and negatively, just like speed.

Business plans, budgets and forecasts are all made on an underlying set of assumptions. The CFO more than anyone else understands how the numbers are generated by those assumptions. The CFO who’s allegiance is bound to the CEO professionally or otherwise is going to give more latitude to short falls in forecasts, budgets and results achieved. In a business that’s traveling at 80 miles per hour and time is of the essence. It is at this juncture that EBITDA may start a precipitous decline that in short order will evaporate equity.

This is not to say that investments only go bad simply because the CFO has a close working relationship with his boss. The issue we have found is one of orientation. The CFO’s first and only loyalty, both professionally and ethically, is to the shareholder.

From this perspective there is a divide that the CFO must effectively straddle. On the one hand the best CFO’s are an integral part of the executive team being accepted as coach, mentor and change agent. On the other, he or she is a champion of realism on behalf of the shareholders. For it is the CFO who has the burden to identify trouble ahead, regardless of how hard the team is working or the optimism expressed by the CEO to stay the course.

Fudging the numbers short term is not the answer. Look at what happens to the capital equipment company that builds machines without signed orders or the consumer products business that ships merchandise to distribution and books the activity as a sale. This is how optimism becomes over optimism.

Cincinnati Milacron and Sunbeam are perfect examples.

The CFO’s first responsibility is to advise the CEO of where performance problems exist and provide time sensitive advice and decision tradeoffs of potential remedies. It is at this point that the shareholders need to be appraised of the situation. To underscore this point lets summarize a real world example.

The CFO of a $300mm leveraged business expressed his concerns to the CEO that a recent bolt on acquisition could not be successfully integrated as originally conceived. For reasons recently discovered the deal would continue to be a major consumer of cash while the company’s core business softened. The CEO remained optimistic and assured the board, comprised of private equity investors, that the business would deliver it’s forecasted EBITDA.

In preparation for his financial briefing to the board, the CFO created two cash flow charts. One under the CEO’s most favorable scenario, the other under more stringent, but realistic conditions, based upon current market conditions. The investors were quick to understand the gravity of the situation and within a week collectively persuaded the CEO on an immediate down sizing of the business and the sale of a non-core division to raise cash before banking covenants were breached.

If the CFO had waited, given deference to the CEO’s optimism, it is certain the entire investment would have been lost. He didn’t because he understood his fiduciary responsibilities and had a comfortable working relationship with the investors.

Most leveraged businesses require a person with substantial financial acumen to be in an executive decision making roll. Often it is the CFO who is the logical succession candidate for the CEO, should the CEO unexpectedly leave or become unable to perform his duties.

For these reasons alone, the investors and/or the board should be proactive in the selection of the best candidate for the CFO position. And once that person is in position, to maintain periodic informal contact to foster an open, unfiltered channel of communication. The added perspective from the CFO provides a healthy balance for any investment.

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